No. SC93162

IN THE SUPREME COURT OF MISSOURI

MINACT, INC.

Respondent

v.

DIRECTOR OF REVENUE,

Appellant

On Petition for Review from the Administrative Hearing Commission

Hon. Sreenivasa Rao Dandamudi, Commissioner

RESPONDENT MINACT, INC.'S BRIEF

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STATEMENT OF FACTS

MINACT, Inc. is a Mississippi corporation that is domiciled and headquartered in Jackson, Mississippi. (LF 1, 85). MINACT is a contractor whose primary trade or business is managing the U.S. Department of Labor's Job Corps Centers located in several states throughout the Southeast and Midwest, including Missouri. (LF 1, 86). MINACT has two Job Corps Centers in Missouri, one in Excelsior Springs and the other in St. Louis. (LF 1, 86).

MINACT elected to apportion its multistate income on its Missouri corporate income tax return based on the three-factor method in the Multistate Tax Compact. § 32.200, RSMo. (LF 1, 12). The Director issued a Notice of Adjustment that changed MINACT's nonbusiness income from all sources from $667,773.00 to $0.00. (LF 1, 108 - 110).

MINACT protested the Director's adjustment. It conceded that $212,378 of the $667,773 should be treated as business income, but contended that the remaining $455,395, representing interest income and capital gains earned by a "Rabbi Trust" should be treated as non-business income. (LF 1, 111 - 113).

A Rabbi Trust is recognized under federal income tax law as a grantor trust established by an employer to provide a "nonqualified" deferred compensation plan. Rabbi Trusts derive their name from a federal letter ruling in which the Internal Revenue Service approved the use of a trust to provide retirement benefits for the rabbis of a Jewish congregation.[1]

[1] Priv. Ltr. Rul. 81-13-107 (Dec. 31, 1980)

In order to qualify for federal Rabbi Trust status, the employer must report the trust's earnings as income on its federal income tax returns. The employer may not deduct contributions to the trust; the employer may take compensation deductions for plan benefits only when such benefits are actually paid to Plan participants. Similarly, the beneficiaries under the Plan do not recognize income when MINACT makes the contributions to the Plan or when Trust's income is allocated to their Plan accounts on the Plan's books. The beneficiaries recognize income only when they actually receive Plan benefits paid by the Trust, upon their retirement, upon other termination of employment from MINACT, or in case of a hardship distribution prior to retirement. Treas. Reg. 1.677(a)-1(d); (LF 1, 89 – 90).

The Director disallowed MINACT's treatment of the $455,395 of the income generated by the Rabbi Trust as "nonbusiness income." (LF 1, 114 – 123).

The Plan

In 1988, MINACT adopted an Executive Deferred Compensation Plan to provide deferred compensation for a group of key managerial and executive employees. Participating employees may defer part of their salaries and bonuses until they eventually retire or leave the company. The company may, in its discretion, pay up to 3% of an employee's yearly compensation as a match. (LF 1, 56: SLF, 25). MINACT is not, however, required to pay a matching amount in any year. (LF 1, 55; SLF, 26).

The funds MINACT uses to match employee contributions come from its excess cash flow. These are "after tax" monies. In other words, MINACT only funds the Trust with

cash that remains *after* MINACT has paid any income tax due on its operational income to Missouri, other states and the United States government. (SLF, 29, 32 – 34).

The Plan is a "non-qualified" deferred compensation arrangement under 26 U.S.C. § 409A. Thus, MINACT does not receive a current deduction for its contributions to the Plan (as it would if the Plan were "qualified" under ERISA) and must currently report as taxable income, all interest, dividends and capital gains earned by investing the contributions and prior years' Plan income (unlike "qualified" plans that would accumulate all such income on a tax-free basis).

About thirty employees have participated in the Plan since its inception. (SLF, 19). There are currently seven Plan participants, including one who lives in Missouri. (SLF, 54).

The Trust

In 1994, MINACT established a "Rabbi Trust" to fund its long-term contractual liabilities owed to its key executives under the Plan. Although Rabbi Trusts may be either revocable or irrevocable, MINACT'S Rabbi Trust is irrevocable. (LF 1, 35). Employees do not have vested rights in the Trust's assets until they are actually entitled to receive benefits under the Plan. (LF 1, 36). The trustee must be an independent third party with corporate trustee powers under state law. To qualify as a Rabbi Trust under

the federal income tax rules, the trust's assets must be subject to the claims of the employer's general creditors in the event of the employer's bankruptcy or insolvency.[2]

The Trustee of the MINACT Rabbi Trust is now known as Regions Bank, the successor after a series of mergers. The Trustee is located in Jackson, Mississippi. It has custody of the Trust's assets and is responsible for making the Trust's investment decisions. (SLF, 31).

MINACT made three contributions totaling $519,061.82 for the 2007 Tax Year (LF 2, 199), and identified its obligations to the Trust as "Long Term Liabilities" on the accompanying Balance Sheet. (LF 2, 245).

Once MINACT's contributions to the Trust have been made, MINACT has no power to direct the Trustee to return or otherwise divert any Trust assets before all payment of benefits required under the Plan have been made. The Trustee makes the Trust's investment decisions, but the Trustee is precluded under the terms of the Trust Agreement from reinvesting the Trust's earnings into MINACT. (LF 1, 39).[3]

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[2] *See* Revenue Procedure 92-64, 1992-2 C.B. 442 for guidelines under which the Internal Revenue Service will rule that an arrangement qualifies as a Rabbi Trust.

[3] MINACT may substitute assets of equal fair market value for any asset held by the Trust in a like-kind exchange. (LF 1, 39). The Trustee may also loan MINACT the proceeds of any borrowing against an insurance policy held as an asset of the Trust. (LF 1, 41). MINACT has never substituted assets in a like-kind exchange or used Trust

Under the terms of the Trust Agreement, the principal of the Trust, and any earnings, are kept separate and apart from other funds of the company. The Trustee must use such principal and earnings "exclusively for the uses and purposes of Plan Participants, and general creditors." (LF 1, 36). The Trust assets are subject to the claims of the company's general creditors under federal and state law in the event of Insolvency, as defined in Section 3(a) herein." (LF 1, 36). The Plan participants would be on par with other general creditors of the company in seeking payment from the Trust's assets in the event of MINACT's bankruptcy or insolvency.

Although the Trust provides that upon termination all of its remaining assets (if any) are to be returned to MINACT, (LF 1, 42), as a practical matter this provision has no effect because the Trust is irrevocable and may not terminate until all participating employees have been paid all of the benefits to which they are entitled. Given that the Plan is a defined contribution plan that requires *all* of the Trust's assets to be distributed to participants, there is no scenario in which any funds will ever be returned to MINACT. (LF 1, 36, 68).

The Trustee keeps a record of how much each employee elects to contribute (including MINACT's match), how much income, dividends and gains each employee's past contributions have earned, and tracks the earnings on these amounts and prior years'

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assets as collateral for a loan, and the Trustee has never loaned money to MINACT or held any insurance policy as an asset. (LF 1, 92; SLF 34-35, 39, 41, and 55).

income through the Trust on an annual basis. The Trust's annual earnings and losses are allocated proportionately to each eligible electing employee's Plan account on the Plan's books based on the Trust's average balance for the year. Specific Trust investments are not identified to each employee, but separate accounts are maintained for each employee in the Plan's books. (LF 1, 52).

The employees bear the investment risk of the Trust. If the Trust's investments lose money, the employees' accrued benefits are proportionately reduced. (LF 1, 57; SLF, 94). Employees are vested in the matching funds over a five year period. (SLF, 49).

MINACT treated the Trust's income as nonbusiness income on its corporation income tax returns filed in the other states in which it does business that are members of the Multistate Tax Compact (Alabama and North Dakota). MINACT reported and allocated 100% of the Trust's income to Mississippi, its state of domicile, and paid Mississippi income taxes on that income. (LF 1, 95, LF 3, 311 – 327; SLF 47 – 53).

SUMMARY OF THE ARGUMENT

The income earned in 2007 by the Trust established to fund MINACT's long-term liabilities under MINACT's Executive Deferred Compensation Plan was nonbusiness income under the § 32.200, the Multistate Tax Compact, because MINACT did not acquire, manage, or dispose of the income-producing property – the Trust corpus. MINACT's only connection to the Trust's income was MINACT's legal liability to pay income tax on the earnings because the Trust was a grantor trust. Accordingly, the income from the Trust was allocable, entirely, to MINACT's state of domicile (Mississippi), and not apportionable to Missouri.[4]

The Director's fixation on MINACT's "business purpose" finds no support in the governing constitutional and statutory principles. It is not even a useful analytical tool in identifying the difference between business and nonbusiness income. *Every* action taken by a business corporation has a "business purpose." Otherwise, the activity would be *ultra vires*. The U.S. Supreme Court rejected the Director's argument more than thirty years ago, noting that using such a rule to define when unrelated businesses are unitary would "destroy the concept." *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 326 (1982).

[4] MINACT paid Mississippi income tax on 100% of the Trust income. Therefore, it did not apportion any of the Trust income to the other Multistate Compact states in which it operates (Alabama and North Dakota). Only Missouri has claimed that the trust income was business income and thus subject to apportionment rather than allocation.

More than twenty years ago, the U.S. Supreme Court held that "the mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions *does not convert an otherwise passive investment into an integral operational one*." *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 788 (1992)(emphasis added). The Court stated that it had previously emphasized the "important distinction between a capital transaction that serves an investment function and one that serves an operational function." *Id*., *citing Container Corp. of America v. Franchise Tax Board*, 463 U.S. 169, 180 n. 19 (1983). Citing *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 326 (1982), the Court noted that: "If that distinction is to retain its vitality, then, as we held in *ASARCO*, the fact that a transaction was undertaken for a business purpose does not change its character." *Id*. (The Appellant's Brief fails to mention *ASARCO* or *Allied-Signal*, and mentions *Container Corp.* only in passing.)

Here, the Trust income resulted from passive investments (directed by the Trustee) that served a long-term corporate goal – to provide funding to pay a long-term contractual obligation created by the Plan. The income did not serve a current operational purpose, and indeed the Plan and Trust documents prohibited the Trust corpus and any income earned on it from *ever* being used by MINACT for any operational purpose because all of the Trust's funds were earmarked for each Plan participant. Even if MINACT were to go bankrupt, the bankruptcy court – not MINACT – would decide the disposition of the funds because such Funds would be available to pay the company's general creditors, including Plan participants.

Finally, although the Director claims that the Trust income meets the so-called "functional" test, it does not meet the statutory criteria on which that test is based. MINACT did not "acquire" the Trust income – it was earned due to the efforts of a third party trustee. MINACT did not "manage" the Trust corpus and income, and thus, MINACT's activity did not produce the income – the independent trustee managed the Trust. MINACT did not "dispose" of the Trust income (it appears none of the income was disposed of or paid out during 2007, but rather the income just accumulated for the benefit of the Plan participants). Any disposition of the Trust corpus or income earned on it would be done by the Trustee. Under state trust law, the third party trustee controlled all aspects of the Trust in accordance with the Trust documents and the Plan. *Only* by virtue of the tax laws did MINACT have any relationship to the Trust's income. Because the Trust is a grantor trust, MINACT as the grantor is legally responsible to pay state and federal income taxes on any income earned by the Trust.

The income earned by the Trust was nonbusiness income, and thus 100% allocable to MINACT's state of domicile, Mississippi. The decision of the Administrative Hearing Commission should be affirmed.

ARGUMENT

Standard of Review

The Court should uphold the decision of the Administrative Hearing Commission if it is "authorized by law and supported by competent and substantial evidence upon the whole record, unless the result is clearly contrary to the reasonable expectations of the General Assembly." *Becker Electric Co. v. Director of Revenue*, 749 S.W.2d 403, 405 (Mo. banc 1988); § 621.193, RSMo 2000. Taxing statutes are to be strictly construed in the taxpayer's favor and against the Director of Revenue. *Brown Group, Inc. v. Administrative Hearing Comm'n*, 649 S.W.2d 874, 881 (Mo. banc 1983).

I.

The U.S. Constitution Prohibits Missouri From Taxing The Trust Income Because The Trust's Assets are Located in Mississippi, Not Missouri, And The Trust Assets Have An "Investment" Rather Than An "Operational" Function

A.

The Mere Existence Of A Business Purpose For Passive Investment Income Does Not Make It Apportionable Income Under The Due Process And Commerce Clauses

There is no question that MINACT has substantial nexus with Missouri because it manages Job Corps Centers in the state. But this alone is insufficient under the Due Process and Commerce Clause provisions of the U.S. Constitution, U.S. Const, art I, §8, cl. 3 and Amend. 14, to allow Missouri to tax the income earned by the Trust because the Trust, and thus the Income it earned, is located in Mississippi. *Meadwestvaco Corp. v.*

Department of Revenue, 551 U.S. 16, 25 (2008). There must be a unitary relationship between MINACT and the Trust. *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 325 (1982).

MINACT and the Trust do not meet the usual test for a unitary business relationship – functional integration, centralization of management and economies of scale – because MINACT manages Job Corps centers and the Trust exists only to invest funds and pay them out in accordance with the Plan. The Trust is not a trade or business, but rather, an investment vehicle.

But the U.S. Supreme Court recognizes that the constitutional requirements may be met regarding capital transactions if the transactions "serve an operational rather than an investment function." *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 788 (1992). This is not a new ground for apportionment, but rather recognition that in some cases an asset can be part of an entity's unitary business even if no unitary relationship exists between the payor and payee. *Meadwestvaco Corp. v. Department of Revenue*, 551 U.S. 16, 29 (2008).

In *ASARCO*, the state sought to tax dividends and capital gains earned by the taxpayer from stock that the taxpayer held in other companies. ASARCO was a mining company whose principal business in Idaho was the operation of a silver mine. The companies in which ASARCO owned stock were also mining companies. The Court held that ASARCO did not control the companies through its stock ownership, and thus the companies did not have a unitary relationship. *See id.* at 323-324.

Idaho argued – as the Director does here – that the test for making the unitary determination should be the corporation's purpose in making the investment. *See id.* at 326. Idaho claimed that intangible income should be considered part of the unitary business if the intangible property is "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business." *Id*.

The court rejected this proposed definition and stated that the "business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently, *all* of its operations, including any investment made, in some sense can be said to be 'for purposes related to or contributing to the [corporation's] business.' When pressed to its logical limit, this conception of the 'unitary business' limitation is no limitation at all." *Id*. at 326.

In *Allied-Signal*, New Jersey argued that two entities need not be engaged in the same business to be considered unitary. It proposed that the Court adopt the principle that common ownership be considered enough to make companies unitary, even though they are engaged different businesses. *See id*. at 784. The Court rejected that notion. New Jersey also contended that there was no difference between short-term investment of working capital and all other investments. The Court rejected that notion as well.

The proper test is whether the "capital transaction serves an operational rather than an investment function." *Id*. at 787. Moreover, the mere fact that the acquisition of an intangible asset serves a long-term business purpose "does not convert an otherwise passive investment into an integral operational one." *Id*. at 788.

MINACT's contributions of after-tax funds (representing its employees' contributions and the employer match) to the Trust are passive investments. Neither the Trust's corpus nor its income is used, or can be used, by MINACT for current business purposes such as working capital. The mere existence of a business purpose – to fund a long-term contractual liability under the Plan whose purpose is, in turn, to attract quality employees – does not convert the nature of these passive investments into operational ones.

The U.S. Supreme Court did not define "operational," but from its contrast between short-term investments used as working capital and long-terms investments made for some eventual business purpose, a temporal element is important to the concept. In *Allied-Signal*, the Court rejected the view that investments that were to be used at some future date for the acquisition of other companies that, once acquired, would be part of the taxpayer's unitary business was sufficient to make the income from such investments apportionable. *Id*. at 788-790.

The Trust's assets consist of a portfolio of stocks, bonds and other securities that are held by the Trust for long-term investment, and do not themselves constitute an active trade or business. (LF 2, 182 – 243). The Trust has but one primary purpose — to hold and invest contributions made by the employees, MINACT's match and income earned from the Trust assets, for the long-term purpose of paying deferred compensation to the qualifying and vested employees.

B.

Other States In Similar Factual Situations Have Held That The United States Constitution Prohibits Apportionment Of Passive Investment Income

State cases applying the constitutional test have reached results congruent with the decision of the Administrative Hearing Commission here.[5]

In *Siegel-Robert, Inc. v. Commissioner of Revenue*, Docket No. 00-3763-III (Tennessee Chancery Court, 2006)(*Siegel-Robert I*), the court, relying upon *Allied-Signal*, held that a Missouri corporation's interest earned on short-term investments in U.S. Treasury securities (held and managed separately in Missouri) were non-business income, allocable 100% to Missouri and not subject to apportionment by Tennessee, even though the investments were for the eventual valid business purpose of acquiring other businesses.

The taxpayer operated a profitable automotive business in numerous states, including Missouri and Tennessee. The taxpayer's automotive business generated sufficient cash to

[5] It is important to note that the constitutional test applies to all states, regardless of whether they have adopted the Multistate Tax Compact. For instance, Tennessee, as discussed in the two following cases, has *not* adopted the Compact and thus, its courts do not apply the Compact's transactional and functional tests. The application of the Compact's two tests, however, are very similar to the application of the constitutional test.

fund the taxpayer's working capital and operational needs. The taxpayer initially kept these excess funds in short-term securities that it segregated for that purpose. When the excess funds exceeded the taxpayer's working capital needs, however, the taxpayer invested the surplus, after tax cash in longer-term U.S. Treasury securities with maturity dates of longer than a year. All of the taxpayer's investment activities took place in St. Louis, Missouri, and not in Tennessee.

In holding that the investment income earned by the U.S. Treasury securities constituted passive income generated by "investment assets," the Court stated:

> First, it is undisputed in the record that the funds were not needed and were not used by the taxpayer for capital replacement or expansion purposes or to fund day-to-day operations. It is further undisputed that the funds were intended by the taxpayer in its long-term investment program for acquiring diversified businesses and that the funds were actually used for that purpose. Additionally, it is undisputed that the amount of funds invested in treasury securities substantially increased during the audit period, that amount was never reduced, and the treasury securities were never sold or used to fund working capital needs. Finally, in distinguishing between an investment function and an operational function, the Supreme Court explained that "the mere fact that an intangible asset was acquired pursuant to a long-term corporation strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one." [*Allied-Signal*] at 788.

Siegel-Robert I, Resp. Appendix at A6.

Tennessee renewed its effort to tax Siegel-Robert's investment income, with a similar adverse result, in *Siegel-Robert, Inc. v. Johnson*, 2009 WL 3486625 (Tenn. App. 2009) (*Siegel-Robert II*). The court found that the funds were invested for the business purpose of shielding the taxpayer's automotive division from times when it might be underperforming. Moreover, some of the funds were actually used to purchase manufacturing assets, but not assets that were used by the automotive division. Thus, the state's proof fell short of showing the necessary unitary relationship. The court rejected Tennessee's claim that the income was apportionable because the investments were for a "business purpose," relying upon *ASARCO*. *Siegel-Robert II*, at 19.

Neither the funds that MINACT contributed to the Trust nor the Trust income was used to conduct MINACT's Jobs Corps business as working capital or otherwise. Just as in *Siegel-Robert I* and *Siegel Robert II*, these excess funds were voluntarily made by MINACT to fund the Trust. There was no requirement for MINACT to make these contributions; however, MINACT did so with excess funds that were not required for daily operations. Thus, the necessary unitary relationship between the Trust income and MINACT's Job Corps operations is missing.

It would be a violation of the Due Process and Commerce Clauses of the U. S. Constitution for Missouri to tax the Trust income. The Trust's assets that generated the Trust's income consisted of a discrete portfolio of stocks and other securities that did not, collectively, constitute a going concern, and the Trust income was not used as working capital or otherwise in MINACT's Job Core Centers management business. Accordingly, the Trust served a long-term investment function with no impact on MINACT's current

business operations. Because the Trust income was earned in MINACT's state of domicile, Mississippi, only Mississippi is constitutionally permitted to tax the Trust income.

II.

(Responsive to Appellant's Point Relied On)

The Income Constituted Nonbusiness Income Under the Multistate Tax Compact

Turning to the statutory issue, nothing in the Multistate Tax Compact. § 32.200, RSMo 2000, compels a different result. Although the Supreme Court declined to adopt the Compact's business/nonbusiness distinction as a constitutional basis for ascertaining the existence of a unitary relationship, it agreed that in the abstract the statutory test could be compatible with constitutional requirements. *Allied-Signal*, 504 U.S. at 786. In this case, the application of the Compact's test is the same. And thus everything in Part I applies with equal force to the business/nonbusiness issue under the statute.

Under the Compact, nonbusiness income is allocated to the taxpayer's state of commercial domicile. Article IV, § 1(1) defines "business income" as: "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." "Nonbusiness income" is all income other than business income. Article IV, § 1(5) .

The Court has held that to qualify as "business income" under the Compact, the income must meet either of two tests:

> First, the "transactional test" determines whether the [income] is attributable to a type of business transaction in which the taxpayer regularly engages. Second, the "functional test" determines whether the [income] is attributable to an activity — namely the acquisition, management, and disposition of property — that constitutes an integral part of the taxpayer's regular business.

See ABB C-E Nuclear Power Inc. v. Director of Revenue, 215 S.W.3d 85, 87 (Mo. banc 2007).

A.

The Trust Income Does Not Meet Either The Transactional Test Or The Functional Test For Business Income Under The Compact

The Director made no attempt to apply the transactional test, and thus concedes that the Trust's income does not qualify as business income under it. The Trust income was not business income that MINACT earned directly from managing its federal Job Corps Centers in the regular course of MINACT's trade or business. Rather, the Trust's income was passive income derived from MINACT's prior years' nondeductible contributions of excess cash to the Trust that MINACT had made over the years (including the Trust's prior years' taxed earnings) for the purpose of eventually funding MINACT's long-term liabilities under the Plan.

The Director relies exclusively on the functional test. But he fares no better there.

Under the functional test, income is business income if it "is attributable to an activity – namely the acquisition, management, and disposition of property – that constitutes an integral part of the taxpayer's regular business." *ABB*, 215 S.W.3d at 87.

The contributions to the Trust were made from MINACT's excess cash flow which, by definition, shows that the contributions were not part of MINACT's regular trade or business. [SLF at 10-13.] The Trust's corpus comes from employee contributions, plus (at MINACT's board's discretion) a company match of up to 3% of these amounts when excess cash flow becomes available. Once MINACT made the contributions to the Trust, it lost all control over their use.

Although MINACT is treated as still owning the Trust corpus and Trust income for federal and state income tax purposes, under state trust law, the Trust and the Plan documents, the Trust corpus and Trust income are available *exclusively* for payments to the participating employees upon their retirement or, in some cases, under certain hardship conditions. The funds are not, and never will be, available for MINACT's regular trade or business – management of Job Corps Centers for the federal government.

MINACT does not manage the trust corpus – that is done by the Trustee, Regions Bank, and Regions Bank is the only entity that is authorized to release the Trust's funds. The trustee, not MINACT, decides what investments to make, and when to make or dispose of them. MINACT does not dispose of the trust corpus or income. Again, that is done by the Trustee in accordance with the Plan documents. Even in the event of bankruptcy or insolvency, MINACT would have no control over the Trust. A bankruptcy court would determine who is entitled to the monies and in what amount. (The Plan participants would themselves be general creditors, and entitled to make claims as such against the Trust.)

The funds in the Trust and the income they earn can only be used to satisfy MINACT's future legal obligations to pay its deferred compensation liabilities to participating employees. MINACT cannot claim any federal or state income tax deductions for either the contributions or the company match when they are made, and the employees do not recognize income at that time. MINACT may only receive deductions for payments and the employees must only report taxable income when the Trust makes payments to those employees.

The Trust income at issue in this dispute represented the 2007 tax year earnings from the Trust's prior years' previously taxed contributions and previously taxed earnings. The Trust income was, accordingly, not generated from acquiring, managing and disposing of property that constituted an integral part of MINACT's business of managing the federal Jobs Corps Centers. It came from segregated assets consisting of excess cash representing previously taxed retained earnings. The Trust income was, accordingly, generated by excess assets that were at least one step removed from MINACT's Jobs Corps Centers business.

This situation is closely analogous to the following example in the Director's Regulations under 12 CSR 10-2.075(D)(6):

> The taxpayer is engaged in a multistate glass manufacturing business. It also holds a portfolio of stock and interest-bearing securities, the acquisition and holding of which are unrelated to the manufacturing business. The dividends and interest income received are nonbusiness income.

Accordingly, the Department's regulations show that taxpayers should treat income and gains from long-term investment portfolios unrelated to the taxpayer's regular business as nonbusiness income.

Under this regulatory guidance, the Trust's income is nonbusiness income. It is earned on non-operating excess funds contributed to and controlled by an independent Trustee. The Trustee is Mississippi bank that makes all investment decisions and holds the assets in a fashion that is legally and physically segregated from MINACT and its Job Corps operations. Once the contributions are made to the Trust, MINACT cannot access these funds for its normal business operations, absent the extraordinary event of MINACT's bankruptcy or insolvency, at which point MINACT's creditors (through the bankruptcy trustee) could attach these funds. It follows that the Trust income, derived from the Trust's assets, represents nonbusiness income that should be allocated to Mississippi under the Director's own regulations and other guidance.

B.

Other States Have Held That Investment Income Derived From Assets Generated From A Company's Excess Cash Held For Long-term Investment Constitutes Nonbusiness Income

One other Compact state supreme court has held that investment income derived from assets generated from a company's excess cash held for long-term investment and segregated from the taxpayer's other business assets constitute nonbusiness income. In *Sperry & Hutchinson Co. v. Department of Revenue*, 527 P.2d 729 (Ore. 1977), the

taxpayer was a New Jersey corporation domiciled in New York doing business in Oregon and most other states.

The taxpayer ran a profitable business of selling trading stamp promotional packages to retailers. The taxpayer invested some of its excess profits from the trading stamp business into three categories of fixed income securities: (1) short-term investments for use in the taxpayer's trading stamp business; (2) short-term investments held for the purpose potentially acquiring other businesses; and (3) long-term investments held for other investment purposes. The taxpayer treated income from all three categories as nonbusiness income under the Compact and allocated the income to New York, its state of domicile.

The Oregon Supreme Court held that the income generated from the excess assets held purely for long-term or short-term investment purposes were not apportionable to Oregon because:

> neither the capital invested nor the income derived therefrom is a part of the trading stamp business conducted in this state. This is equally true both under the current Uniform Division of Income for Tax Purposes Act (ORS 314.605 to 314.670) which became effective beginning 1965 and under the pre-existing statute (ORS 314.280). Both statutes impose a tax on an interstate corporation only as to income attributable to Oregon and do so through minor variations on the concept of "unitary business." We hold that because S&H's long-term investment income was neither "closely connected or necessary" under the old statute, nor "income arising from transactions…in the regular course of the

> taxpayer's" trading stamp business under the new statute, the interest is not apportionable. . . .
>
> The short-term securities held pending favorable developments in the long-term money-market or acquisition of other businesses are in precisely the same position as the long-term investments. They are not a part of the stamp business and, therefore, are not apportionable to Oregon.

Id. at 730.

MINACT's net income generated *directly* from its Job Corps Center business is business income, subject to apportionment, and is subject to tax as business income as it is earned. That income is not at issue here. Once MINACT accumulates after-tax cash (*e.g*., retained earnings) that is not necessary to fund its day-to-day operations, and contributes these funds to the Trust, neither the Trust corpus nor the Trust income can be used by MINACT for the day-to-day operations of its Job Corps Centers. That MINACT has segregated those funds to eventually pay its long-term liabilities to certain of its key-employees is also not relevant, because presumably all long-term investments made by a company would be made for some kind of valid business purpose (*e.g*., in *Sperry* or under the Director's regulations, for future acquisitions).

III.

(Responds to Appellant's Point Relied On)

The Director's Reliance On *Hoechst Celanese Corporation v. California Franchise Tax Board* Is Misplaced.

The Director's case is built upon the decision of the California Supreme Court in *Hoechst Celanese Corporation v. California Franchise Tax Board*, 25 Cal.4th 508, 22 P.3d 342 (2001) , *cert. denied*, 534 U.S. 2040 (2001). That case involved surplus assets that had been purchased with business income that had never been subjected to income tax, and that were returned to the company after the termination of a "qualified" pension plan. The excess pre-tax funds were placed in the company's "general fund to be used for general corporate purposes." 25 Cal. 4th at 516, 22 P.3d at 330. A qualified plan under the Internal Revenue Code is one that meets certain minimum funding standards as determined annually by an actuary. (MINACT's Plan is unqualified and has no such requirement. MINACT has no obligation to match any contributions by its employees, let alone make a contribution in any particular amount.)

When Hoechst's plan accumulated assets in excess of the amount necessary to fund the plan's future fixed benefit obligations, Hoechst could legally freeze the benefits at their existing level, terminate the plan and take back the excess assets for use in its trade or business. This is exactly what happened: Hoechst froze its plan benefits, terminated its plan and all of the excess assets reverted to the company.

The California court gave short shrift to the state's claim that the income at issue met the transactional test. The reversion of excess assets to Hoechst was not part of the taxpayer's regular trade or business. *See id.*, 25 Cal.4th at 527, 22 P.3d at 336 - 337.

The court then turned to the functional test. It examined in great detail the meaning of the words "acquisition, management and disposition," and concluded that the functional test does not require the taxpayer to have legal title to the property generating the income to be nonbusiness income. 25 Cal.4th at 565, 22 P.3d at 339. The court *did* hold, however, that the statutory language "establishes that the taxpayer must: (1) obtain some interest in *and* control over the property; (2) *control or direct* the use of the property; and (3) transfer, or have the power to transfer, control of the property in some manner." 25 Cal.4th at 528, 22 P.3d at 338 (emphasis added).

Unlike Hoechst, MINACT does not control or direct the use of the property – funds previously contributed to the Trust – during the tax year. Under the terms of the Trust, the funds are entirely controlled by the Trustee. MINACT cannot, as Hoechst did, terminate the Trust. The funds are invested by the trustee for the ultimate benefit of the Plan participants, not for MINACT.

Also MINACT's Plan is a defined contribution plan, not a defined benefit plan like Hoechst's plan, so by definition, the overfunding in Hoechst could never happen to MINACT. The Trust is irrevocable. Although there is a nominal provision in the Trust for returning excess funds to MINACT, it will never be effective because the terms of the Trust and Plan *require* that all of the Trust's corpus and each employee's proportionate share of the Trust's earnings (if any) must be paid to each employee. If the Trustee

follows the terms of the Plan, there will be no funds to return to MINACT because all of the Trust's assets are earmarked for the participants. Even if the company were to go bankrupt, the assets, including any earnings, would be earmarked for the benefit of the Plan participants and the company's other general creditors.

The California court then considered what makes control of the property "integral" to the taxpayer's regular trade or business. The court concluded that "integral" means something less than "necessary or essential," and something more than "contributing to." Its solution was to add the word "materially" to the latter phrase to hold that the taxpayer's control and use of the property must "contribute materially" to the production of business income. 22 P.3d at 339.

Hoechst's addition of one word to tests already rejected by the U.S. Supreme Court in *ASARCO* and *Allied-Signal* sheds no light on the issue here, and ignores an important component of the statutory language – that the control of the property be an integral part of the taxpayer's current regular business operations. As noted above in Part I, there is a temporal component that cannot be ignored. The income must be used for current activities, and not be the result of long-term investments, even long-term investments that may ultimately culminate in a current business activity in the future.

Hoechst is also distinguishable on its facts. *First*, the taxpayer actually received the reversionary interest with no restrictions on its use. The funds were placed in the company's general fund where they were immediately available to be used for general corporate purposes. As noted, neither the Trust corpus nor the income it earned will ever revert to MINACT. The monies are irrevocably earmarked for payment to the Plan

participants (or the company's general creditors in the event of bankruptcy) to satisfy a long-term contractual obligation.

Second, one of the considerations that the Hellerstein treatise (relied on by the Director) said was a fundamental ground of tax policy was the issue of "tax equity." The taxpayer in *Hoechst* had never paid any taxes on either the funds it contributed to the pension trust or the income that it earned because it was a qualified employee benefit plan under federal law. The taxpayer got to deduct its contributions to the plan, and thus reduce its apportionable income. "Under tax benefit principles" Hellerstein said, "one may argue with some force that amounts previously deducted from apportionable income as business expenses should be restored to the taxpayer's tax base as apportionable income when they are 'recaptured' in the form of pension reversion income." HELLERSTEIN & HELLERSTEIN, *State Taxation*, ¶ 9.13[1][a], S9-21 (3d ed., 2013 Cum. Supp.), Appellant's Appendix at A42. This, however, is not the situation in a Rabbi Trust when the Trust is irrevocable, as in MINACT's case.

By contrast, in *Sperry*, *Siegel-Robert I and II*, and MINACT's situations, the income in question was derived from *previously taxed income*. The excess cash had been either set aside as investments or contributed to the trust for investment purposes *in prior years*. These companies set aside and invested some of their previously taxed retained earnings that were not necessary for their day-to-day business operations and invested it for some future valid business purpose. None of these companies was ever entitled to deduct the amounts that they set aside for long-term investment purposes and all of them had to pay income taxes on the income earned from the set aside amounts.

Thus, the MINACT Plan is *not* a qualified plan under the Internal Revenue Code. MINACT contributed after-tax dollars to the Trust, meaning that every penny in the Trust comes out of its apportionable income and has already been taxed by Missouri and other states, as well as by the federal government. Moreover, every penny of the income earned by the Trust is subject to state and federal income tax – to be paid by MINACT. MINACT only receives a deduction when the benefits are actually paid. There are no tax equity grounds to support taxation of the Trust income as apportionable income.

Notably, the excerpt from the Hellerstein treatise cited by the Director does not take issue with this analysis or the Commission's decision rejecting *Hoechst* as inapplicable. HELLERSTEIN & HELLERSTEIN, §9.13[1]1[b], Appellant's Appendix at A43.

Finally, the Director relies upon a brief passage in a lengthy administrative decision from Virginia rejecting a taxpayer's claim that income earned by a rabbi trust was nonbusiness income. Va. Tax Comm'r Ruling 03-60 (2003) (appdx. A37-40). Initially, we note that an administrative decision on an issue of law is not entitled to any deference, even if the decision is made by our own Administrative Hearing Commission, let alone an official of another state government.

The basis for the administrative officer's decision was the taxpayer's total failure to provide any evidence or explanation as to why the income of the rabbi trust in that case should be considered nonbusiness income. For example, the decision does not indicate whether that trust was revocable or irrevocable. If the former, it becomes more like the *Hoechst* case where the taxpayer was allowed to terminate the trust.

The Director also cites Hellerstein's endorsement of the Virginia decision, which is unburdened by any actual analysis of the relationship between the taxpayer and the Rabbi Trust – which even Hellerstein noted was the critical evidence. HELLERSTEIN & HELLERSTEIN, §9.13[1]1[b], Appellant's Appendix at A44.

There is ample evidence in the record here to support the finding that MINACT did not control the Trust in such a way as to make its income an integral part of its regular business or trade operations. The investment in the Trust and the income earned by the Trust were long-term investments to satisfy a long-term contractual commitment, not operational investments related, materially or otherwise to the company's day-to-day operations. The income therefore was nonbusiness income.

CONCLUSION

For these reasons, MINACT, Inc. requests that the Court affirm the decision of the Administrative Hearing Commission and grant such other relief as the Commission deems proper under the circumstances.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

The undersigned hereby certifies that this brief complies with the limitations in Rule 84.06(b), and it contains 7,075 words, excluding the parts of the brief exempted; and has been prepared in proportionally spaced typeface using Microsoft Word 2010 in 13 point Times New Roman font.

/s/ James W. Erwin

CERTIFICATE OF SERVICE

The undersigned hereby certifies that the foregoing was served through the Missouri CaseNet electronic filing system this 20th day of September, 2013 upon the following:

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/s/ James W. Erwin

No. SC93162

IN THE SUPREME COURT OF MISSOURI

MINACT, INC.

Respondent

v.

DIRECTOR OF REVENUE,

Appellant

On Petition for Review from the Administrative Hearing Commission

Hon. Sreenivasa Rao Dandamudi, Commissioner

RESPONDENT MINACT, INC.'S APPENDIX

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SIEGEL-ROBERT, INC., Plaintiff. v. RUTH E. JOHNSON, in her capacity as Commissioner of Revenue for the State of Tennessee, Defendant.

Case Information:

Docket/Court: 00-3763-III, Tennessee Chancery Court

Date Issued: 08/17/2006

Tax Type(s): Franchise Tax

OPINION

MEMORANDUM AND ORDER

The plaintiff, a foreign corporation with headquarters in St. Louis, Missouri, who does business in a number of states including Tennessee, filed the above-captioned lawsuit seeking a refund of excise taxes for tax years ending July 31, 1996; July 31, 1997; and December 31, 1997, pursuant to the Taxpayer Remedies for Disputed Taxes Act section 67-1-1801, *et seq.* The Commissioner of Revenue denies that the plaintiff is entitled to a refund.

The issue in this case pertains to interest the taxpayer earned on short-term investments. The taxpayer asserts that the interest is entirely investment income and is not used for operating its business. The Commissioner asserts that the liquidity of the income makes it susceptible to being used as working capital to operate the business. The distinction made by the parties as to investment versus operating funds has significant legal implications because under Tennessee and federal constitutional law, business earnings are apportioned for taxing purposes among the states where the taxpayer pays franchise and excise taxes, Holiday Inns, Inc. v. Olsen, 692 S.W.2d 850, 852 (Tenn. 1985) , such that if the funds in this case are determined to be business earnings. Tennessee would have the right to tax the interest income in dispute. On the other hand, nonbusiness earnings are allocated for tax purposes solely to the state of the taxpayer's domicile. Tennessee not being the taxpayer's domicile, Tennessee would not be permitted to tax the funds if they are nonbusiness earnings.

At the outset, there are two preliminary matters the Court shall address. First, the plaintiff taxpayer has withdrawn any refund claim on its investments earned in repurchase agreements. At issue is solely the plaintiff's earnings on U.S. treasury securities.

Secondly, in response to the plaintiff's motion to strike, the Commissioner has withdrawn her request for this Court to use facts from another case, Swope v. Siegel-Robert, Inc., 74 F. Supp. 876 (E.D. Mo. 1999) . As to the remainder of the plaintiff's motion to strike, the Court grants it.

Based upon these preliminary matters and after reviewing the record, papers of counsel and considering the arguments, the Court concludes that the earnings in issue are nonbusiness earnings which serve an investment function and, therefore, are not taxable by the Stare of Tennessee. Accordingly, the Court denies the Commissioner's motion for summary judgment and grants summary judgment in favor of the plaintiff. The Court's reasoning is as follows.

The material facts in this case are essentially undisputed. Taken from the Statements of Undisputed Material Facts, the Court concludes the following facts are established by the record:

Siegel-Robert is a foreign corporation with its commercial domicile in St. Louis, Missouri. *Defendant's Response to Plaintiff's Statement of Materials Facts ("SMF")* ¶ 1.

Siegel-Robert is comprised of several operating business units. *Plaintiff's SMF* ¶ 4. The largest business unit is its automotive division which manufactures decorative parts for the automotive industry. *Plaintiff's SMF* ¶ 5. During the audit period, Siegel-Robert manufactured other products through separate subsidiaries for a variety of diverse industries. *Plaintiff's SMF* ¶ 6.

The only business activity of Siegel-Robert conducted in Tennessee during the audit period was manufacturing of decorative plastic parts at two manufacturing plants in Tennessee. *Defendant's Response to Plaintiff's* SMF ¶ 8.

Siegel-Robert's automotive division generated sufficient cash from operations to fund its capital replacement and [working capital] requirements. *Defendant's Response to Plaintiff's SMF* ¶ 10 (except Defendant objects to Plaintiffs use of term "working capital").

Over the years, Siegel-Robert accumulated surplus funds in excess of the operational and [working capital] needs of Siegel-Robert's various business units. *Defendant's Response to Plaintiff's SMF* ¶ 11 (except Defendant objects to Plaintiff's use of term "working capital").

Siegel-Robert transferred its accumulated excess funds to its investment portfolio and earned interest on the invested funds. *Defendant's Response to Plaintiff's SMF* ¶ 12.

When the amount of accumulated cash significantly exceeded the daily operational and [working capital] needs of Siegel-Robert's business units, Siegel-Robert transferred such excess funds from overnight investments in repurchase agreements to longer term investments in United States treasury securities, including U.S. Treasury Notes and U.S. Treasury Bills, with maturity dates typically from one to one and one-half years. *Defendant's Response to Plaintiff's SMF* ¶ 14 (except Defendant objects to Plaintiff's use of term "working capital").

The funds invested in treasury securities and the interest income earned thereon were not used by Siegel-Robert during the audit period for capital expansion or replacement purposes or to fond the day-to-day operations of Siegel-Robert. *Defendant's Response to Plaintiff's SMF* § 17.

The United States government was the payor of the interest income earned on Siegel-Robert's United States treasury securities. *Defendant's Response to Plaintiff's* SMF ¶ 14.

All of Siegel-Robert's investment activities were conducted in St. Louis, Missouri, and not in Tennessee. *Defendant's Response to Plaintiff's SMF* ¶¶ 22-23. The payor of the interest income on the invested funds was the United States government. *Plaintiff's SMF* ¶ 21. Mr. Halvor Anderson was Siegel-Robert's Chief Executive Officer during the audit period and he developed Siegel-Robert's investment program in United States treasury securities. *Plaintiff's SMF* ¶¶ 22, 32. Mr. Anderson handled all of the investment activities for Siegel-Robert and he conducted all of the activities from Siegel-Robert's commercial domicile in St. Louis, Missouri. *Plaintiff's SMF* §§ 22, 33. None of those investment activities were conducted in Tennessee. *Plaintiff's SMF* § 22. All of the funds invested in United. States treasury securities were held by Siegel-Robert's bank in St. Louis," Missouri, as custodian for Siegel-Robert. *Plaintiff's SMF* ¶ 23.

Siegel-Robert accumulated and invested excess funds in United States treasury securities for the intended use in Siegel-Robert's investment program to diversity by acquiring other businesses. *Defendant's Response to Plaintiff's SMF* ¶¶ 34-35.

Siegel-Rober'st actual use of the excess funds invested in United States treasury securities was to implement its strategy of diversification by acquiring other businesses. *Defendant's Response to Plaintiff's SMF* ¶¶ 26-28, 36.

From 1982 through 1997, the end of the audit period years, Siegel-Robert acquired thirteen diverse companies. *Plaintiff's SMF* ¶¶ 26, 27. Siegel-Robert funded its acquisitions with cash from its maturing investments in U.S. treasury securities and without incurring debt. *Plaintiff's SMF* ¶ 26, 27. The businesses acquired by Siegel-Robert each had good management teams in place to continue to ran the businesses on a decentralized basis with the day-to-day operations conducted by people who managed the businesses at the time of acquisition. *Plaintiff's SMF* ¶¶ 37, 38. The acquired businesses were maintained as separate entities and were not integrated with Siegel-Robert's automotive business. *Plaintiff's SMF* ¶ 39. The acquired businesses maintained their own local bank accounts, separate payrolls, separate payables. separate receivables, separate billing, separate sales force, separate engineering staffs and other personnel. *Plaintiff's SMF* ¶ 40.

With the foregoing facts in mind, the Court turns to the law. The governing Tennessee tax statutes in this case are section 67-4-801 and 811. [1] Under those statutes, a taxpayer with earnings from business activities taxable both within and outside of Tennessee is

required to allocate and apportion its earnings. “Allocation” is the assignment of earnings to a specific taxing jurisdiction, such as the taxpayer's domicile; “apportionment” is the division of earnings among the multiple states in which the taxpayer does business. If a taxpayer's earnings are classified as “nonbusiness earnings, ”they are allocated to a specific taxing jurisdiction pursuant to the terms of section 67-4-810. Under the terms of section 67-4-811, earnings that are classified as “business earnings” are subject to apportionment.

“Business earnings” were defined in Tennessee Code section 67-8-804(a) and at (b). Law more specific to the issues in this case is provided by the decision of the Tennessee Supreme Court in Holiday Inns, Inc. v. Olsen, 692 S.W.2d 850 (Term. 1985) , addressing the question of when interest income constitutes business earnings. After reviewing *Holiday Inns,* this Court concludes that the Tennessee Supreme Court held in that case that interest earnings, which arise from transactions and activities in the regular course of the business and that are derived from capital earned in the business and then invested in short-term investments for future business activity to meet operational and working capital needs, constitute business earnings.

In the case at bar, the Undisputed Statements of Material Facts establish that the funds invested in U.S. treasury securities were derived from overnight investment in repurchase agreements. Thus the earnings in issue were an investment layer removed from capital earned in the business. Additionally, the interest earned on the U.S. treasury securities in this case was not used by the taxpayer to put back into the business for operational and working capital needs. The securities interest earned served an investment function. Distinguishable both in derivation and use from the earnings in *Holiday Inns,* the Court concludes that the interest in this case constitutes nonbusiness earnings. The Court, therefore, grants the plaintiff's motion for summary judgment and denies the Commissioner's motion for summary judgment.

The other basis on which this Court grants the plaintiff's motion for summary judgment and denies the Commissioner's motion is a constitutional one.

In Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992) , the United States Supreme Court held that the constitutional limits of a state's power to tax under the Due Process and Commerce Clauses is that there must be “some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax.” 504 U.S. at 777. Significantly, the Court stated that “there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.” *Id.* at 778. Using the “unitary business principle” to define the limits of the State's power to tax under these circumstances, the United States Supreme Court recognized three indicia of a unitary business: (1) functional integration; (2) centralized management; and (3) economies of scale.” *Id.* at 781. The unitary' business principle requires a unitary relationship between the business conducted by a nondomiciliary corporation within the taxing state and another business conducted by the nondomiciliary corporation outside

the taxing state before the taxing state can require the nondomiciliary corporation to include in its apportionable income the income derived from the activity conducted outside the taxing state. *Id.* at 777-83. If the taxpayer's income-generating activities outside of the taxing state are not connected to the taxpayer's business activities within the taxing state, the unitary business principle limits the power of the taxing state to apportion that income as business earnings.

Allied-Signal was then referenced by the Tennessee Court of Appeals in Louis Dreyfus Corp. v. Huddleston, 933 S.W.2d 460 (Term. Ct App. 1996), perm. app. denied (Term. 1996) . The Court of Appeals found in that case that the inquiry focuses "on the underlying unity or diversity of the business, and on the relationship between the activities of the component in the taxing state and the activities occurring elsewhere, not just on the common relationship between the various components and the central structure of the business." *Id.* at 467. In *Louis Dreyfus,* the taxpayer engaged in several lines of business, one of which generated the subject income, and the issue was whether there was a unitary relationship among those businesses.

Applying the *Louis Dreyfus* case and its constitutional analysis to the case at bar, the Court concludes that the relationship between the taxpayer's manufacturing activities in Tennessee as the taxing state and the taxpayer's investment activities in Missouri is that the manufacturing activities in Tennessee are wholly unrelated to the investment activities in St. Louis. Missouri. The record establishes that the taxpayer's investment activities in Missouri were not related to or dependent on the activities of the automotive division in Tennessee and that the activities of the automotive division in Tennessee were not related to or dependent upon the taxpayer's investment activities in Missouri. The taxpayer's investment activities were conducted separate and distinct from the business of its automotive division. Further, the Court agrees with the analysis of the taxpayer that the mere fact that the taxpayer's automotive business and its investments in treasury securities are owned by the same corporation does not satisfy the unitary business principle.

There is another aspect of *Allied-Signal* which must be addressed in this case. It is similar to the analysis above concerning "nonbusiness" earnings under the Tennessee Act. In *Allied-Signal,* it was undisputed that the taxpayer and the source of the subject of the income (in that case the investment was a minority stock interest in another corporation) did not have a unitary relationship. Nevertheless, the Supreme Court held that income may also be apportionable where a taxpayer's investment serves an operational function rather than an investment function. *Id.* at 787. Using the term "working capital" the United States Supreme Court stated that even in the absence of a unitary business, a state may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another state if that income formed part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank.

Focusing on the significance of "working capital" to the Supreme Court in *Allied-Signal,* the Commissioner argues in the case at bar that the investments are working capital because they are highly liquid, *i.e.,* they can be sold anytime, prior to their maturity and were listed alongside cash under the taxpayer's audited consolidated financial statements for the audit period. The Court rejects that argument.

Although the funds were liquid, the balance of the facts establish that the funds cannot be classified as working capital. First, it is undisputed in the record that the funds were not needed and were not used by the taxpayer for capital replacement or expansion purposes or to fund day-to-day operations. It is further undisputed that the funds were intended by the taxpayer in its long-term investment program for acquiring diversified businesses and that the funds were actually used for that purpose. Additionally, it is undisputed that the amount of funds invested in treasury securities substantially increased during ihe audit period, that amount was never reduced, and the treasury securities were never sold or used to fund working capital needs. Finally, in distinguishing between investment function and operational function, the Supreme Court explained that "the mere fact that an intangible asset was acquired pursuant to a long-term corporation strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one." *Id.* at 788.

These other indicia, the Court concludes, overcome the liquidity aspect of the earnings and cause the Court to conclude that the taxpayer's investments in treasury securities were not held for or used as working capital. Hence, this case does not fit within the *Allied-Signal* rubric of income which forms part of the working capital of the corporation's unitary business.

Having concluded that the interest income earned on the taxpayer's investments in U.S. treasury securities was nonbusiness earnings and that Tennessee is prohibited under federal constitutional principles from subjecting the interest income to apportionment for Tennessee excise tax purposes, the Court grants the plaintiff's motion for summary judgment and denies the cross motion for summary judgment of the Commissioner.

It is therefore ORDERED that the plaintiff's motion for summary judgment is granted; the defendant's motion for summary judgment is denied. This is not a final order. If counsel for the parties seek to convert this ruling into a final order, they shall submit to the Court a proposed final order addressing court costs and any other outstanding issues.

/s/

ELLEN HOBBS LYLE

CHANCELLOR

cc: Patricia Head Moskal

Joseph W. Gibbs

Stuart Richeson

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[1]

Statutory references provided herein are those of Tennessee Code Annotated provisions as they were when this dispute originally arose. Since that time, former sections 67-4-801 *et seq.* were repealed by the state legislature and replaced at sections 67-4-2001 *et seq.* (the "Excise Tax Law of 1999"). Herein the Court retains the original statutory citations provided by the parties.

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